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UNCLAS SECTION 01 OF 04 MEXICO 005044

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NSC FOR RICHARD MILES, DAN FISK

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TAGS: [ECON](#) [ELAB](#) [EFIN](#) [PINR](#) [PGOV](#) [MX](#)

SUBJECT: MEXICAN CONGRESS APPROVES LONG-SOUGHT TAX REFORM

REF: A. MEXICO 4970

[1](#)B. MEXICO 4815

[1](#)C. MEXICO 4552

[1](#)D. MEXICO 4282

[1](#)E. MEXICO 4280

[1](#)F. MEXICO 4236

[1](#)G. MEXICO 4191

[1](#)H. MEXICO 4151

[1](#)I. MEXICO 4015

[1](#)J. MEXICO 3246

[1](#)K. MONTERREY 725

[1](#)1. (SBU) SUMMARY: Mexico's Senate approved an overhaul of the country's tax laws on September 14 -- a move that will strengthen public finances and give President Calderon another legislative victory. The Chamber of Deputies has already approved the bill, so most of the reforms only require the Executive's signature to be published in the Official Gazette and become law. The reform introduces an alternative minimum corporate tax, creates a tax on cash deposits, increases the gasoline tax by 5.5%, and enacts some measures to strengthen tax collection. The reform will boost government revenues by 1.1% of GDP in 2008, a figure that gradually increases to 2.1% of GDP by 2012. While the scope of the reform is limited, it is a step in the right direction and it sends a positive signal regarding Calderon's ability to pass other economic reforms. END SUMMARY.

[1](#)2. (U) Mexico's Senate approved an overhaul of the country's tax laws on September 14 -- a move that will strengthen public finances and give President Calderon another legislative victory. The Chamber of Deputies has already approved the bill, so most of the reforms only require the Executive's signature to be published in the Official Gazette and become law. A few measures related to the supervision of public accounts must pass through state legislatures since they entail changes to the constitution.

[1](#)3. (U) Under Secretary of Finance Alejandro Werner remarked publicly that the reform will have a direct impact on public

finances and will promote greater economic growth. Government officials expect the measures to increase real GDP growth in 2008 from 3.5% to 3.7%. Werner added that the passage of the bill sends clear signals to domestic and foreign investors that Mexico has begun to work on a more solid and competitive economy. Werner added that the bill opens the door for movement on labor, energy, and educational reform.

14. (U) The reform will boost government revenues by 1.1% of GDP in 2008, a figure that gradually increases to 2.1% of GDP by 2012 (vs. 1.5% and 2.8%, respectively, in the original tax proposal). Note that these figures do not include the effects of a tax hike on gasoline or a tax cut for Pemex. When a new tax on gasoline is excluded, approximately 70% of the additional resources will go to the federal government and 30% to the federal entities. Calderon has pledged to use the extra federal resources for infrastructure, education, and health programs.

Key Components of the Bill

15. (SBU) Large parts of the reform proposal the administration unveiled in June remained intact, but the government was forced to make a number of concessions to appease business and interest groups to secure backing from the opposition. Some of these changes watered down the bill, while others were improvements.

Public Revenues

MEXICO 00005044 002 OF 004

16. (SBU) The heart of the bill is an alternative minimum tax called the Single Rate Corporate Tax (IETU for its initials in Spanish), which is intended to respond to criticism of loopholes companies in Mexico use to significantly lower their tax bill. Werner has said publicly that congressional changes to this tax have made it more "friendly" to investment. The tax, which allows fewer deductions than the regular income tax, will be set at 16.5% next year and will rise to 17% in 2009 and 17.5% in 2010 (vs. 19% in 2010 in the original proposal). Salaries will generally be creditable under the IETU, and employee benefits will generally be deductible. New investments made in the fourth quarter of this year will be deductible over the next three years. For investments in fixed assets, deferred expenses and charges, the bill grants a tax credit against the IETU at a rate of 5% during the next 10 years. The proposal also allows tax deductions for charitable donations (with some restrictions) as well as deductions for private schools and small agricultural producers. According to the Department of Treasury's Tax Policy Office, the USG and GOM have been in discussions regarding the creditability of the IETU against U.S. income taxes but have not made any public announcement.

17. (SBU) A 20% excise tax (IEPS) on gambling and lotteries was approved, while a proposed tax on aerosol paints was rebuffed. The bill repeals the Assets Tax (IMPAC), and removes tax exemptions on stock sales that involve a change of control of a company, or the sale of more than 10% of a company's stock in a 12-month period. Mexican Stock Exchange Deputy Director General Pedro Zorrilla said publicly that the change will not inhibit investment, noting that the benefits of financing through the stock market will offset any negative impact. Edgar Camargo, the Head of Economic Research at Bank of America in Mexico (strictly protect throughout), told econoff that while at first glance this change may raise concerns, it "is not a big deal" since it only affects "very large amounts of money." Referencing the mergers of BBVA and Bancomer and Citibank and Banamex, he said the government is trying to avoid large transactions taking place tax free.

Tax Cut for Pemex

¶18. (U) Legislators also approved measures that will free up more cash for Pemex to invest to stem declining oil production. The rate on the ordinary fee on hydrocarbons is reduced from 79% currently to 74% in 2008, and it falls to 71.5% by 2012. The move cuts USD 2.7 billion from Pemex's tax bill in 2008 and USD 5 billion by 2012. The reform boosts the amount of resources dedicated to scientific and technological research, and it requires Pemex to carry out a program to increase its operational efficiency, following approval from the Secretariat of Energy.

¶19. (SBU) Camargo remarked that the PRI pushed for these measures because it wanted to make sure Pemex received a part of the additional resources from the tax reform and because it wanted to strengthen its links to one of the country's most important unions. He remarked that he was not particularly pleased with the initiative, but that he would wait and see if Pemex spent the money wisely. Hacienda officials on several occasions have told econoffs that they wanted to improve Pemex's efficiency and transparency before giving the company more resources.

¶10. (SBU) That said, many industry analysts argue that the measures provide much-needed tax relief since Pemex's high tax bill leaves it with little to devote to exploration and refining. Mexico already imports 40% of its refined oil products, and its oil reserves are expected to fall over the next decade.

MEXICO 00005044 003 OF 004

Tax Administration

¶11. (U) The bill levies a 2% tax on cash deposits exceeding 25,000 pesos (USD 2,294) per month, an attempt to attack tax evasion in Mexico's vast informal economy. This "Tax on Cash Deposits" is creditable against the income tax and other federal contributions. It will become effective on July 1, 2008 to give banks time to prepare their systems to collect the tax. Most remittances as well as payments made in cash to repay loans granted by financial institutions are not subject to the tax.

¶12. (U) The majority of Calderon's proposals to strengthen auditing and control procedures were approved. In particular, Congress is given more power to audit federal transfers to the states; fines to advisors and service providers are increased; shared responsibility is established when a firm changes its address without proper notice; and new rules are established regarding a taxpayer's obligation to provide authorities documentation during an audit.

Fiscal Federalism

¶13. (U) The bill enacts a 5.5% increase on federal gasoline and diesel taxes, the proceeds of which will go to state and municipal governments for investment in infrastructure projects. The planned rate hikes will be implemented over an 18-month period. This tax is transitory and will be suspended if a (failed) proposal that would have allowed federal entities to levy products subject to the federal excise tax (IEPS) is approved at the local level, and any state incorporates the local sales tax. HSBC economist Alejandro Martinez (strictly protect throughout) told econoff the reform package "does almost nothing" to improve fiscal responsibility and transparency at the state level. He added that the states were the biggest winners of this reform because they secured additional income without having to assume the political costs of raising taxes.

¶14. (U) The bill creates two funds: the Hydrocarbon Extraction Fund for states where oil is extracted, and the Compensation Fund for the 10 states with the lowest non-mining and non-oil related GDP per capita. The latter, which aims to direct resources to the poorest states, will be financed with approximately 20% of the revenues from the new gasoline tax.

Public Spending

¶15. (U) The bill stipulates that the Executive Branch must reduce its operating and administrative expenditures by 5% per year in coming years, with a final goal of trimming 20%. In lieu of creating a National Council of Public Policy Evaluation, the bill established general principals that will be the basis of performance evaluations made by public institutions that have this function. The reform also requires government-owned companies to create "austerity programs," and it promotes greater competition in government acquisitions.

¶16. (U) It is worth noting that a few measures regarding the supervision of public accounts entail changes in the constitution, and therefore must be approved by local legislatures. The Chamber has approved these measures, but the Senate has yet to ratify them.

Reaction to the Bill

MEXICO 00005044 004 OF 004

¶17. (SBU) Some local pundits have highlighted the many concessions the government made to secure the opposition's backing for this reform. They note that the final reform bill is "too little" and that it came at too high a price. Alejandro Martinez remarked that market followers are already asking how much Calderon will have to concede to secure passage of more difficult initiatives, such as energy reform. Some business leaders continue to argue that the new measures will hurt investment and economic growth.

¶18. (SBU) Most market observers, however, agree that while the reform is limited, it is a step in the right direction. Camargo told econoff the reform sends a positive signal regarding Calderon's ability to govern and pass other economic reforms down the road. He underscored that it was not simply the passage of the reform, but rather the fact that Calderon was able to advance his agenda while working with the opposition in Congress. From his point-of-view, it is better to have passed a slightly less ambitious reform that kept "the channels of communication open," than to have secured approval of the government's initial proposal but left severe divisions among political parties.

¶19. (SBU) Camargo told econoff that the reform will probably lead Standard & Poor's to upgrade Mexico's sovereign rating by yearend. He noted that other factors, including the heat rating agencies have taken for not warning about trouble in the sub-prime market, could delay the expected outcome. While an upgrade would not result in a huge market rally, it would be welcome news to financial markets. Martinez was slightly less optimistic, noting that he expected the upgrade in early 2008.

Comment

¶20. (SBU) The tax reform bill should be seen for what it is, a first step forward. The approval of this reform represents another victory in Congress for Calderon and an important step for a country that has not approved any significant tax reform measures in a decade. Importantly, the reform will

help Calderon address falling oil production and keep pace with rising health and pension commitments as Mexico's population ages. This reform opens the way for the administration to push other much-needed initiatives, such as streamlining its cumbersome legal system, improving its educational system, and undertaking labor and energy reform.
End Comment.

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